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Supreme Court, U.S.
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No.

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1997

LEW WARDEN and NADJA J. WARDEN,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE.

On Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Ninth Circuit

PETITION FOR WRIT OF CERTIORARI

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A. QUESTIONS PRESENTED FOR REVIEW

1. Does the equal protection component of the due process clause of the Fourth Amendment, combined with the status of the Tax Court of the United States as a court of national jurisdiction, mandate that the tax laws of the United States, in this case sections 162, 183, and 212 of the Internal Internal Revenue Code, be applied uniformly throughout the United States irrespective of contrary and conflicting opinions of and between the several Circuit Courts of Appeals?

2. Must a judge of the Tax Court follow opinions of panels of the Court of Appeals to which an appeal may be taken, that in cases arising under sections 162, 183, and 212 of the Internal Revenue Code, the burden is on the taxpayer to prove that his primary or dominant purpose in entering into an activity was to "profit", rather than applying the Tax Court's established standard that it is sufficient compliance with these sections that he prove an "actual and honest" intent" to profit?

3. Does Commissioner v. Groetzinger, 480 U.S. 23, 35 (1987), direct that in order to qualify as a business, the primary and dominant purpose of the taxpayer in commencing an activity must be to "profit", as distinct from and to the exclusion of "producing income"?

4. In determining whether the "primary" purpose of the taxpayer is to "profit",

where the taxpayer has multiple motives for commencing an activity, is it the burden of the taxpayer to "convince" the trial court that his primary intent was to profit, or, once multiple motives have been shown to exists, should the trial court, as held by this Court in Commissioner v. Soliman, 506 U.S. 168, 174-175 (1993), undertake a comparative analysis of such motives to determine which was primary?

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Appendix A, p. 1.

Memorandum opinion of United States Court of Appeals for the Ninth Circuit, No. 95-70896, filed April 2, 1997. Not for publication.

Appendix B, p. 2.

Memorandum of Opinion of United States Tax Court, Docket no. 4829-92, T.C. Memo. 1995-176, filed April 17, 1995.

Appendix C, p. 12.

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1997

PETITION FOR WRIT OF CERTIORARI

Petitioners respectfully pray that a writ of certiorari issue to review the judgment below.

OPINIONS BELOW

The Memorandum opinion of the United States Court of Appeals, no. 95-70896, filed April 2, 1997 appears at Appendix B, p. 3, to the petition and is unpublished.

The Memorandum of Opinion of the United States Tax Court, no. 4829-92, filed April 17, 1995, appears at Appendix C to the petition, p. 12, and is published as T.C. Memo. 1995-176.

JURISDICTION

The opinion of the Ninth Circuit Court of Appeals, sought to be reviewed was filed April 2, 1997. Petitioners filed timely petition for rehearing with suggestion for rehearing en banc, which petition was denied by unpublished order filed August 20, 1997, appearing herein as Appendix A.

Jurisdiction exists by reason of Rule 10, and 28 U.S.C. sec. 1254(1).

CONSTITUTIONAL PROVISIONS, STATUTES AND REGULATIONS INVOLVED IN THE CASE

Amendment IV, United States Constitution:
No person shall be deprived of life, liberty, or property, without due process of law.

Internal Revenue Code, Title 26, U.S.C.
Sec. 162, Appendix F, p. 44.
Sec. 167, Appendix F, p. 44.
Sec. 183, Appendix F, p. 44.
Sec. 212, Appendix F, p. 46.

Treasury Regulations
26 CFR 1.183-2, Appendix F, p. 46.
1.212.1(c), Appendix F, p. 48.

STATEMENT OF THE CASE

This petition involves conflicts between between the Ninth Circuit and at least seven of the other Circuit courts of appeal, conflicts between the Tax Court and panels of the Ninth Circuit, and conflicts between the judges of the Tax Court.

The focus of these conflicts is whether, in determining if a particular activity qualifies as a "trade or business" under I.R.C. sec. 162, the test or standard by which the taxpayer's intent to profit is determined, the taxpayer had an "actual and honest" intent to profit, which is the rule of the Tax Court and the Second, Fourth, Sixth, Seventh, Eighth, Eleventh, and District of Columbia Circuits, or the "primary and dominant" intent to profit test applied by a dissenting Tax Court judge in the instant case and upheld

by a panel of the Ninth circuit, and the related issue of whether a taxpayer's subjective intent should be a matter of judicial concern at all.

A second issue involves the duties of the Tax Court and the Internal Revenue Service to apply the tax laws uniformly among the several states, and the correlative right of the individual taxpayer, under the equal protection component of the Due Process clause to the uniform application of the tax laws.

A third issue involves the scope and application of this Court's opinions in Commissioner v. Groetzinger, 480 U.S. 23, 35 (1987) and Commissioner v. Soliman, 506 U.S. 168, 174-175 (1993) to sections 162, 183, and 212 of the Internal Revenue Code, and the proper resolution of the question of how the trial court should determine which, of multiple taxpayer's motivations, are primary.

The facts of this case, for the purposes of this petition, are substantially as set forth in the Tax Court's Memorandum of Opinion. (Appendix C, pp. 13-25.) We briefly review them to orient the Court to the plight petitioners found themselves in as a consequence of a failed business venture.

Petitioner Lew Warden (herein Lew) is a is a retired attorney, and petitioner Nadja Warden (herein Nadja) is his wife. In 1986 Lew, then 66 years old, sought to withdraw from the practice of law and to earn petitioners' livelihood in the charterboat business.

To this end the Wardens purchased a 55-foot sailboat, which they named Rocking Chair, from Windships, Inc., a yacht brokerage firm in Oakland, California, and, in 1987, placed the yacht in service in Windships' charter department.

Within a matter of months--because Windships was not performing its obligations to commission the yacht, to provide warranty support to remedy the numerous mechanical problems which developed, and to provide petitioners with the volume of charters it had represented petitioners could expect--it became apparent to petitioners that their project was in jeopardy. In order to extricate themselves from this situation, petitioners did most of the commissioning and repair work themselves and put the yacht up for sale.

In 1988, under the impact of declining yacht sales due to changes in policy by the Commissioner, Windships went out of business, Rocking Chair continued to have major mechanical failures which made it inoperable for for extended periods of time, and Lew moved out of his apartment and onto the yacht in order to reduce expenses and to be close to the work which he and others were doing on the yacht, and continued listing it for sale. (At the time, Nadja was living in the family home in San Luis Obispo, California.)

In 1989, Lew moved the yacht to Southern California in search of a better sale market and chartering opportunities. There he continued working to repair the boat's defects, obtained a few charters, and experienced fur-

ther major mechanical failures. In 1989, petitioners sold their property in San Luis Obispo, and purchased a home in Castro Valley, California.

In late 1990, the yacht's mechanical problems still persisting, Lew gave up any further efforts to charter the yacht, filed a lawsuit (ultimately successful) against Windships and the yacht's Taiwanese builder, and brought the yacht back to Northern California for major repairs.

After this work was done, Lew again placed the yacht for sale with a yacht broker, but withdrew the offering when a marine surveyor reported that although the yacht still had a substantial value, because of its history of problems and petitioners' obligation to fairly disclose such problems to prospective buyers, for all practical purposes it was unmarketable.

The trial judge, in an effort to divine petitioners' profit intent at the time they first purchased the yacht, extensively reviewed their post-purchase activities, placed his own interpretation of these events and concluded that petitioners had failed to "convince" him that their "primary" intent was to profit. (Appendix C, p. 34.)

The trial judge applied this test, at the behest of counsel for respondent, in lieu of the Tax Court's long-established more lenient "actual and honest" standard, because the case was appealable to the Ninth Circuit. (Appendix C, p. 27.)

Crucial to petitioners' appeal to the Ninth Circuit and this petition are the following findings by the trial judge:

1. Petitioners "honestly hoped that their yachting activity would generate a profit." (Appendix C, p. 32.)

2. "Profit was one objective of their activity." (Ibid.)

3. To prevail, "petitioners must show that their yachting activities were engaged in primarily for the purpose of making a profit." (Ibid.)

4. Petitioners "were ready to retire and wanted to live in a pleasant, recreational setting." (Appendix C, p. 33.)

5. "Based upon the entire record, we are not convinced that petitioners' primary objective was to make a profit." (Ibid.)

6. "Rather, the evidence is more consistent with the conclusion that petitioners wished to retire from the practice of law, had a desire to sail, had the financial resources to pursue that desire, and had some hope that they could combine their dream retirement with an income-producing venture." (Ibid.)

In reaching his conclusion, the Tax Court judge did not undertake the kind of objective comparative analysis mandated by this Court in Commissioner v. Soliman, 506 U.S. 168, 174-175 (1993), but rather based his determination on petitioners' failure to sustain their burden

to "convince" him that their intent to profit was their primary motivation in entering into the charterboat business.

Pursuant to the provisions of 26 U.S.C. secs. 7481-7483, petitioners appealed to the Court of Appeals for the Ninth Circuit from the Memorandum of Opinion of the Tax Court (Appendix C) upholding determinations by respondent Commissioner of Internal Revenue disallowing petitioners claimed deductions for the tax year 1989. The Court of Appeals, while recognizing that other circuits followed a different rule, affirmed on the ground that the Ninth Circuit followed the primary intent to profit standard. (Appendix B, pp. 5-7.) The Court of Appeal also rejected petitioners' contentions made herein that the Tax Court, as a court of national jurisdiction, was obliged to apply its own rule absent binding precedent, and that its failure to apply a uniform standard denied petitioners due process of law. (Appendix B, pp. 10-11.)

REASONS FOR GRANTING THE WRIT

A

SUBSTANTIAL CONFLICT EXISTS BETWEEN THE DECISIONS OF THE NINTH CIRCUIT AND THE DECISIONS OF AT LEAST SEVEN OTHER CIRCUITS AS TO THE CORRECT STANDARD TO BE APPLIED TO THE DETERMINATION OF WHETHER AN ACTIVITY IS A "TRADE OR BUSINESS" UNDER I.R.C. SEC. 167

Although sec. 167 of the Internal Revenue Code does not expressly so provide, it has long been judicially established that

the intent to profit is an essential element in the determination of whether a particular activity is a "trade or business" under sec. 162. As Judge Swift, in his concurring opinion in Peat Oil & Gas Associates, et al., v. v. C.I.R., 65 TCM 2259 (1993)*, at p. 14, fn 2, noted: "[T]he primary standard first appeared as a judicial gloss on the statutory language of section 165(c)(2) in Helvering v. National Grocery Co., 304 U.S. 282 (1938)".

Until recently, the Tax Court almost invariably followed the rule, first approved by the District of Columbia Circuit Court of Appeals in Doggett v. Burnett, 62 App. D.C. 103, 65 F.2d 191 (1933), that the question of whether a taxpayer had the requisite "intent to profit" was to be determined by whether he had "an actual and honest" intent to profit. Hence, we, as do professional practitioners see "Equine Endeavors: Hobby v. Business", Florida Bar Journal (March 1989), pp. 33, 36 n. 4) refer to the "actual and honest"

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* Also reported as Peat Oil and Gas Associates v. C.I.R. (1993) 100 T.C. 271. Peat is a very significant case as it sets forth the differing views of the several Tax Court judges on the issues raised herein, views which help explain the differences between the several Circuits and underline the need for this Court to exercise its supervisory powers and to settle important questions of federal tax law. All of the issues presented herein, save the constitutional issue, are discussed and highlighted by the several Tax Court judges in Peat.

test as the Tax Court's rule. The Tax Court also often cites Dreicer v. C.I.R., 665 F.2d 1292 (DC Cir. 1981) as authority for its rule.

In 1959, a panel of the Ninth Circuit, citing Doggett v. Burnett, supra, held that a "good faith" intent to profit was sufficient to establish the requisite profit fit motive, and reversed a Tax Court ruling against the taxpayer. (Brooks v. C.I.R., 274 F.2d 96 (9th Cir. 1959).)

Four years later another panel of the Ninth Circuit, also citing Doggett v. Burnett, supra, sustained a Tax Court's ruling against the taxpayer and, by way of dicta, stated that the test was whether the taxpayer had entered into the questioned activity in "good faith, with the dominant hope and intent of realizing profit, i.e., taxable income". (Hirsch v. C.I.R., 315 F.2d 731, 736-737 (9th Cir. 1963).) As indicated by the Ninth Circuit's opinion herein (Appendix B, p. 5), in subsequent opinions the concepts of "good faith", "hope", and "income" were dropped and the Ninth Circuit's test, as distinguished from that of the Tax Court and the several other circuits referred to herein, became simply the "primary or dominant intent to profit".

Further, as applied by the trial judge herein, and affirmed by the Court of Appeals, this test became a stand-alone, virtually insurmountable obstacle to the taxpayer, not a test requiring objective judicial comparison with other taxpayer motivations, as indicated by this Court in Commissioner v. Groet-

zinger, 480 US 23, 35-36 (1987) and Treasury Regulations sec. 1.212.1(c). (Appendix E, pp. 47-48.) See Commissioner v. Soliman, 506 U.S. 168, 174-175 (1993) where this Court in a closely analogous situation calling for the judicial determination of primacy, held that the trial court must make a comparative analysis of the alternative factors.

The following cases from the Second, Fourth, Sixth, Seventh, Eighth, Eleventh, and District of Columbia circuits, all applying the Tax Court's traditional "actual and honest" intent to profit standard, and being, according to our latest research, the latest published opinions of these circuits, highlight the differences between the Ninth Circuit and these other circuits:

Ranciato v. C.I.R., 52 F.3d 23, 25 (2nd Cir. 1995); cf. Ferguson v. C.I.R., 29 F.3d 98, 102 (2nd Cir. 1994).

Hendricks v. C.I.R., 32 F.3d 94, 97 (4th Cir. 1994); cf. Antonides v. C.I.R., 893 F.2d 656, 659 (4th Cir. 1990).

Smith v. C.I.R., 937 F.2d 1089, 1093 (6th Cir. 1991).

Burger v. C.I.R., 809 F.2d 355, 358 (7th Cir. 1987).

Evans v. C.I.R., 908 F.2d 369, 1373 (8th Cir. 1990).

Osteen v. C.I.R., 62 F.2d 356, 358 (11th Cir. 1995).

Cornfield v. C.I.R., 797 F.2d 1049 (D.C. Cir. 1986).

We have also collected, in Appendix D, pp. 39-41, a random sampling of some 42 post-Commissioner v. Groetzinger Tax Court cases

(from some 229 sec. 183 cases reported by Commerce Clearing House), all appealable to the Ninth Circuit, and only four of which mentioned the Ninth Circuit's rule, much less indicated an obligation to be bound by it.

Although most of these recent Tax Court cases do not suggest that other judges of the Tax Court are about to abandon the traditional "actual and honest" test, the fact that some judges feel obliged to cite both standards or to otherwise equivocate on the issue, suggests some uncertainty, blurs the essential distinction between the two tests, and obscures the rights of the parties.

The distinction between these two tests not only is emphasized by the outcome of petitioners' case, but also is demonstrated by a post-Commissioner v. Groetzinger opinion by the same Tax Court judge as here and where, on remarkably parallel facts--although in our biased opinion, we believe we had much the stronger case--the court upheld the taxpayer against the Commissioner by applying the "actual and honest" test. (Dennis A. Pryor, 61 TCM 2139 (1991).

Compare Judge Swift's plea in Peat Oil and Gas Associates v. C.I.R. (1993) 100 T.C. 271, 285-286, that the Tax Court, the forum most likely to be adversely impacted by the resolution of such a subjective matter as a taxpayer's primary intent, be spared such burdens. If judicial standards are too ephemeral, decisions become "ad hoc and episodic", and contravene accepted due process principles. (Rochin v. California, 342 U.S. 165, 172 (1951).)

In concluding this section, we note that in Portland Golf Club v. Commissioner, 497 U.S. 154 (1990), Justice Kennedy, in a partially concurring opinion, joined in by Justice O'Connor and Justice Scalia, wrote that he saw "no justification for making the profit-motive requirement more demanding than necessary to distinguish trades and businesses from other activities pursued by taxpayers."

B

THE COURT SHOULD MANDATE A PROCEDURE WHEREBY THE TAX COURT MAY EFFICIENTLY FULFILL ITS OBLIGATIONS AS A COURT OF NATIONAL JURISDICTION WITHOUT CHALLENGING THE OBLIGATIONS OF THE CIRCUIT COURTS OF APPEALS TO DECLARE THEIR VIEWS ON TAX LAW

With 12 Circuit Courts of Appeal, most often acting through lesser panels, faced with the responsibility for resolving appeals from a flood of Tax Court decisions by individual Tax Court judges, not to speak of appeals from the many District Courts within their respective jurisdictions, it is small wonder that basic conflicts on points of tax law develope within the system.

However, while the federal court system and the complexity of the tax laws necessarily create diversity of opinion, it is not seemly that the Internal Revenue Service and the Tax Court should complicate the process by themselves advancing diverse points of view.

In theory, uniformity of opinion on matters of law is imposed upon the Internal

Revenue Service by the Treasury Regulations. (United States v. Correll (1967) 389 U.S. 299, 305-306.) But in fact, the Internal Revenue Service has never felt the constraints of "petty consistency", and takes its victories wherever and however it can find them.

The Tax Court has a policy--of some 40 years duration and restated from time to time--whereby it may assert its views on a particular point of tax law against contrary opinion by a particular Circuit court.

Thus, in Peat Oil and Gas Associates v. C.I.R. (1993) 100 T.C. 271, a remarkably illuminating opinion in which all 15 of the Tax Court judges made their views known on the issues of "profit" motives and conflicts between the Tax Court and the Courts of Appeals, the Court spoke to its policy of refusing to defer to contrary Circuit opinion unless the Tax Court had first been reversed on precisely the same point, and to hold to its opinion until the matter has been ruled upon by this Court.

This policy, flowing from its status as a court of national jurisdiction and its duty to apply the tax laws uniformly, has been articulated in numerous other Tax Court cases, e.g., Lawrence v. C.I.R., 27 T.C. 713, 716-717 (1957), revd. on other grounds 258 F.2d 562 (9th Cir. 1958); Golsen v. C.I.R., 54 T.C. 742, 757 (1970), affd. 445 F.2d 985 (10th Cir. 1971); Estate of Willis Edward Clack, 96 TC 4562 (1966); Krumhorn v. C.I.R., 103 TC 29,

30-31 (1993), an opinion by same trial judge who deferred to 9th Circuit dicta herein; Lardas v. C.I.R., 99 TC 490, 494 (1992).

This policy, as set forth in the Tax Court's majority opinion in Peat, is as follows:

(1) The Tax Court will "follow a Court of Appeals decision which is squarely in point where the appeal from our decision lies to that Court of Appeals and that court alone." (Golsen v. C.I.R., 54 T.C. 742, 757 (1970), affd. 445 F.2d 985 (10th Cir. 1971).)

(2) If appeal from the Tax Court's decision "lies to a Court of Appeals that does not have a decision squarely in point, we, as a court of national jurisdiction, must thoroughly reconsider an issue in light of the reasoning of a reversing appellate court and, if still of the opinion that our original result was right, follow our own beliefs until the Supreme Court decides the point." (Lawrence v. C.I.R., 27 T.C. 713, 716-717 (1957), revd. on other grounds 258 F.2d 562 (9th Cir. 1958).

However, and for reasons not disclosed in its opinion, this policy manifestly was not followed by the Tax Court judge in petitioners' case. Indeed, the opinions of the Ninth Circuit relied upon by the judge in his opinion (Appendix C, p. 27) and cited by the Ninth Circuit panel herein (Appendix B, p. 5) did not involve reversals of Tax Court decisions but rather were opinions sustaining the Tax Court's decisions on their facts, facts

which were entirely unrelated to those of petitioners' case. Nor did the Tax Court judge or the Ninth Circuit panel herein recognize the existence of two Ninth Circuit holdings which reversed Tax Court decisions by applying the "good faith" intent to profit test to facts which are similar to the facts herein. (Brooks v. C.I.R., 274 F.2d 96 (9th Cir. 1959); Mercer v. C.I.R., 376 F.2d 708 (9th Cir. 1967).)

The willingness of the Tax Court judge in this case to break ranks with the Tax Court's policy of defending its national jurisdiction in the interest of uniformity of tax law, suggests that other devices may be required to assure such uniformity.

Our review of the many appeals from Tax Court determinations in this area of law, persuades us that rarely do the Courts of Appeal take issue with the Tax Court on matters of tax law, and that rarely do the decisions of the Tax Court involve varying interpretations of law. Rather, Tax Court trials usually are are fact-finding proceedings, and the Courts of Appeal, quite appropriately, extend great deference to those fact determinations.

Thus it does not seem appropriate, even though theoretically within their jurisdiction, that the Circuit courts--particularly panels of those courts--should challenge the Tax Court in its determinations of tax law in the usual case. Indeed, we might reasonably suppose that it is of no great moment to the orderly administration of the tax laws and the national fisc that the Tax Court should be left free to follow its

rule that an individual taxpayers intent to profit--if such indeed must be a requirement of sec. 162--is established if he has shown an "actual and honest" intent to profit.

However, the contrary is not true. It is of great moment to the trial judge and to the individual taxpayer if the taxpayer must "convince" the trial judge, or, more appropriately, prove by a preponderance of evidence, that his "primary" motivation was to make a profit. For in such case the court and the parties--as this case well illustrates--are at sea in a welter of testimony and evidence subject to all manner of interpretation and conflict. It is for this reason that Judge Swift pleads for respite. (Peat Oil and Gas Associates v. C.I.R. (1993) 100 T.C. 271, 285-286.)

We submit that this Court should craft a rule which will complement the Tax Court's policy, a rule which would recognize the obligations of both the Tax Court and the Circuit Courts of Appeals, and yet reduce the potential for conflict between the several circuits and the Tax Court. We submit that the Court, on the one hand, should approve the Tax Court's policy while directing that the individual tax judges should not resolve individual cases on points of law upon which a majority of Tax Court judges have not agreed, and, on the other hand, directing that the Circuit courts follow a correlative policy of declining to review Tax Court opinions which are based upon principles of tax law upon which the Tax Court has not "spoken as one voice", and should reverse such opinions with directions that the Tax Court reconsider

the matter and reach uniformity of opinion on the particular point of tax law.

The Tax Court struggles to establish uniformity of tax law, as is its mandate, but under the pressures of the enormous volume of cases it processes, it must rely on decisions by individual judges, a number of whom do not share the same views, and some of whom may be so convinced of the merit of their own views as to proceed with ad hoc rulings designed to advance such views. Certainly, it appears from Peat that the Tax Court judges are seriously divided on this profit issue--which has a far wider range of application than merely to hobby cases--and could well use a clarifying opinion by this Court.

As matters now stand, the Tax Court does not appear to have any mechanism whereby a litigant, caught up in this controversy, can move the Tax Court to establish uniformity of opinion on matters of tax law among its several judges prior to having an adverse decision by an individual judge passed on to a court of appeals for review, a process which contributes to diversity of opinion, conflict, and the unequal application of the federal tax laws.

C

THE COURT SHOULD AFFIRM THAT ITS STATEMENTS IN COMMISSIONER vs GROETZINGER WERE NOT INTENDED TO ESTABLISH "PRIMARY INTENT TO PROFIT" AS A STAND-ALONE TEST FOR DETERMINING WHETHER AN ACTIVITY IS A TRADE OR A BUSINESS OR A MEANS OF PRODUCING INCOME, BUT RATHER AS A METHOD

OF DISTINGUISHING HOBBY-TYPE ACTIVITIES

It seems apparent, from the paucity of Tax Court opinions mentioning Commissioner v. Groetzinger, 40 U.S. 23 (1987), that the Tax Court judges are having difficulties in fitting all of that opinion into the overall picture of tax cases impacted by profit-motive questions.

However, the Court of Appeal herein cited Groetzinger (see Appendix B, p. 5)--although notably the Tax Court did not--as support for its "primary" intent to profit rule. But petitioners do not believe that this Court intended that its comments on primacy have such sweeping applications.

It appears abundantly clear that the sense in which this Court used the expression "primary" was merely to distinguish a business or income-producing activity from a "hobby or an amusement diversion". (Ibid. at pp. 35-35.) Which is completely in accord with I.R.C. sec. 212 and Treasury Regulation 1.212.1(c). (Appendix E, pp. 45, 47-48.)

D

THE COURT SHOULD DECLARE THAT IN DETERMINING WHETHER A QUESTIONED ACTIVITY IS A TRADE OR BUSINESS OR INCOME PRODUCING ACTIVITY, AS DISTINCT FROM A HOBBY OR AMUSEMENT DIVERSION, THE COURTS BELOW SHOULD UNDERTAKE A COMMISSIONER vs SOLIMAN COMPARATIVE ANALYSIS TO DETERMINE WHICH ACTIVITY IS PRIMARY

The manner in which the primary intent rule should be applied is an important is-issue of novel impression. No Ninth Circuit

decision stating the rule has explored its parameters or discussed how this stringent and highly subjective test is to be applied. Nor did the Court of Appeals herein mention our discussion of Commissioner v. Soliman , 506 U.S. 168, 174-175 (1993), and contention that it should be applied to the Tax Court's findings in this case.

In Soliman this Court discussed the analogous issue of whether a physician's home or the hospitals in which he practiced was his "principal place of business", and held that the determination of this question requires a court to make a comparative analysis of "the relative importance of the activities performed at each business location and the time spent at each place."

Similarly, courts cannot objectively assess whether any one purpose is primary or dominant without comparing it to the other purposes which motivated the taxpayer to enter into or continue a questioned activity. And since, as shown by the instant case, the determination of the taxpayer's intent is determined by his actions rather than his own statements, it follows that the actions taken to show one purpose or another must be analysed, weighed, and compared before the ultimate conclusion is reached.

Although petitioners have not been able to establish that the Soliman rule of analysis has received appellate court consideration in this context (cf. Snyder v. U.S., 674 F.2d 1359, 1363-1364 (10th Cir. 1982), the Tax Court on several recent

occasions has discussed and applied this rule in precisely the sense in which petitioners contend it ought to be applied:

Lynn Crawford, 65 TCM 2540, 2544 (1993).
Christos Coutsoubelis, 66 TCM 935, 938-939 (1993).
Ruth Giesbrecht, 69 TCM 2149, 2151 (1995), appealable to 9th Circuit.
Peat Oil & Gas Associates, 65 TCM 2259, 2264-2265 (1993).
Owen A. Steinberg, 69 TCM 2121, 2136 (1995).

Even the trial judge herein had previously recognized that Soliman, taken in the profit context, requires the court to undertake a comparative analysis of alternative motives (Peat Oil & Gas Associates v. C.I.R., 100 TC 271, 291 (1993), he omit- to do so in the instant case.

CONCLUSION

Petitioners respectfully urge the Court to grant certiorari to review these important tax matters. The institutional pressures all tend toward diversity and conflict. And only this Court is positioned to establish uniformity, a daunting picture for one seeking the Court's attention. But the volume of tax cases is so great, and the invitation to litigate engendered by conflicting, confusing, and uncertain court decisions so alluring, that surely a great positive gain can be anticipated from a ruling of this Court that will not only remove uncertainty and diversity from the narrower issues at hand, but also from the institutional sug-

gestions we have raised herein to limit conflict between the Tax Court and the Courts of Appeals.

Respectfully submitted this 17th day of November, 1997.

Lew Warden,
Petitioner.

Nadja J. Warden,
Petitioner

No.

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1997

LEW WARDEN and NADJA J. WARDEN,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE.

On Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Ninth Circuit

APPENDICES TO PETITION FOR WRIT OF CERTIORARI

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APPENDIX A

NOT FOR PUBLICATION

FILED
Aug 20 1997
Cathy A. Caterson, Clerk
U.S. Court of Appeals

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

LEW WARDEN and NADJA J. WARDEN,	)	No. 95-70896
	)	
Appellants,	)	Tax Court
	)	No. 4829-92
v.	)	
	)	
COMMISSIONER OF INTERNAL REVENUE,	)	ORDER
	)	
Respondent.	)	
	)	

Before: SCHROEDER AND O'SCANNLAIN, Circuit Judges, and KELLEHER, * District Judge.

The panel as constituted above has

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*Honorable Robert J., Kelleher, Senior United States District Judge for the Central District of California, sitting by designation.

voted to deny the petition for rehearing and to reject the suggestion for rehearing in banc.

The full court has been advised of the suggestion for a rehearing en banc and no judge of the court has requested a vote on the suggestion for rehearing en banc. Fed. R. App. P. 35.

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

(N.B. No date or signature provided.)

APPENDIX B

NOT FOR PUBLICATION

FILED
Apr 2 1997
Cathy A. Caterson, Clerk
U.S. Court of Appeals

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

LEW WARDEN and NADJA J. WARDEN,	)	No. 95-70896
	)	
Appellants,	)	Tax Court
	)	No. 4829-92
v.	)	
	)	
COMMISSIONER OF INTERNAL REVENUE,	)	MEMORANDUM
	)	
	)	
Respondent.	)	
	)	

Appeal from the United States Tax Court
Robert P. Ruwe, Tax Court Judge, Presiding
Argued and Submitted February 13, 1997
San Francisco, California

Before: SCHROEDER AND O'SCANNLAIN,
Circuit Judges, and
KELLEHER,** District Judge.

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* This disposition is not appropriate for publication and may not be cited to or by

Mr. and Lew Warden and Mrs. Nadja Warden ("Appellants") challenge the findings of the U.S. Tax Court. In its Memorandum Opinion of April 17, 1995, the Tax Court held that expense deductions taken by Appellants--alleged to have been incurred in relation to a yacht chartering business--were improper. See I.R.C. secs. 162; 183. The Tax Court, applying the "primary" or "dominant" purpose test, determined that the yachting activity was not engaged in with the primary purpose of making a profit. Appellants contend that the Tax Court incorrectly applied the primary purpose test in lieu of the more lenient "good faith" test. Appellants further contend that even under the primary purpose test, the Tax Court's finding was clearly erroneous. Because the Ninth Circuit precedent is clear that the primary purpose test governs, and because Appellants have not shown clear error, we affirm the judgment of the Tax Court.

Decisions that are asserted to have misapplied a given "profit" rule are to be reviewed de novo. See North Ridge Country Club v. Commissioner, 877 F.2d 750, 755 (9th Cir. 1989). There can be no question,

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the courts of this circuit except as provided by Ninth Circuit Rule 36-3.

** Honorable Robert J., Kelleher, Senior United States District Judge for the Central District of California, sitting by designation.

however, as to whether the Tax Court applied the correct rule. Section 183 deals with attempted deductions for activities not engaged in with the proper profit motive. See I.R.C. sec. 183. Sec. 162, for its part, deals with allowable deductions as to activities that are engaged in with the proper profit motive. This section allows the deduction of ordinary and necessary expenses paid or incurred in connection with the operation of a trade or business. See I.R.C. sec. 162.

For an activity to generate deductions under section 162, we have clearly stated that a taxpayer must show "that the activity was entered into with the dominant hope and intent of realizing a profit." Vorsheck v. Commissioner, 933 F.2d 757, 758 (9th Cir.) cert. denied, 502 U.S. 984 (1991). We have held that "[p]rofit must be the predominant, primary or principal objective . . . . ." Wolf v. Commissioner, 4 F.3d 709, 713 (9th Cir. 1993); see also Polakoff v. Commissioner, 820 F.2d 321, 323 (9th Cir. 1987); Independent Elec. Supply v. Commissioner, 781 F.2d 724, 728-29 (9th Cir. 1986) ("Independent Electric"); Carter v. Commissioner, 645 F.2d 784, 786 (9th Cir. 1981); Hirsch v. Commissioner, 315 F.2d (9th Cir. 1963). Though other circuits may apply a different standard, our holdings in this area are in line with those of the Supreme Court. See Commissioner v. Groetzinger, 480 U.S. 23, 25 (1987); United States v. American Bar Endowment, 477 U.S. 105, 110 n.1 (1986).

The correct test having been applied

by the Tax Court, our second duty is to evaluate its conclusion that the yachting activity did not carry with it the requisite profit motive. We have held that "[a] finding of to profit motive must be affirmed on appeal absent clear error." Wolf, 4 F.3d at 712 (citing Independent Elec., 781 F.2d at 727). We must uphold the Tax Court's finding unless we are "left with the definite and firm conviction that a mistake has been committed." Id. Further "[i]f the [Tax Court's] account of the evidence is plausible in the light of the record viewed in its entirety, the court of appeals may not reverse it even though convinced that had it been sitting as the trier of fact, it would have weighed the evidence differently." Service Employees Int'l Union v. Fair Political Practices Comm'n, 955 F.2d 1312, 1317 n.7 (9th Cir.), cert. denied, 505 U.S. 1230 (1992).

The Tax Court determined that the engagement in a trade or business--though possibly a purpose--was not the primary purpose of the yachting enterprise. The Tax Court concluded its findings as to profit motive by writing:

> Based on the entire record, we are not convinced that petitioners' primary objective was to make a profit. See Snyder v. United States, 674 F.2d 1359, 1362-64 (10th Cir. 1982). Rather, the evidence is more consistent with the conclusion that petitioners wished to retire from the practice of law, had a desire to sail, had the financial resources to pursue that desire, and had some

hope that they could combine their dream retirement with an income-producing ture.

Appellants essentially contend that the Tax Court gave certain pieces of evidence too much or too little weight.

Without offering explanation or support in the case law, Appellants first assert that several findings of fact were not supported by "substantial evidence". These six factors are: that Appellants had the financial resources to retire, that the yacht was used for alternative purposes other than chartering, that Appellants took long trips on the yacht, that mechanical failures could have been foreseen had proper research been performed, that Appellants should have prepared a written business plan, and that both Appellants loved to sail. Appellants assert that there not "substantial" evidence to support the Tax Court's implicit findings of fact as to each of these facts. Yet employing the "clearly erroneous" standard of review, we find that as there was a basis

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1. Facts that Appellants suggest were not considered but do appear in the Tax Court's opinion are as follows: (i) that Appellants had attempted to acquire an interest in a recreational facility in Pleasanton, California, where they hoped to retire; (ii) that mechanical failures caused the losses related to the yacht; (iii) that Appellants engaged in some business-like activity; (iv) that Appellants prosecuted

for each of the findings--that is, each is supported by the record--we must affirm the judgment of the Tax Court.

Appellants then list several facts that they assert that Tax Court did not properly consider. This assertion is patently absurd given that a majority of the facts are specifically referenced in the Tax Court's memorandum and the remainder of the facts are expressly noted in Mr. Warden's Trial Memorandum--which was admitted into evidence in lieu of direct testimony by Mr. Warden--and are nonetheless dealt with in the Tax Court judgment in some fashion. (fn 2.) Given that each fact was present in the record before the Tax Court and most were referenced explicitly in the Tax Court opinion, there is no basis for us to presume that these facts were not considered. In assessing a similarly situated taxpayer's previous challenge to a Tax Court's findings, we wrote

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litigations against the manufacturers and sellers of the yacht; and (v) that real losses, beyond mere depreciation expenses were felt.

2. Facts that the court did not specifically reference but were either present in Mr. Warden's testimony or summarized in slightly different terms include: (i) that there was a 12 year absence between Appellants' ownership of their prior boat and their ownership of the Rocking Chair in 1986 (the opinion instead stated that Mr.

that "[a]t best . . . appellants manage only to show that their activities might have had a profit motive; they do not show that the Tax Court was clearly erroneous . . . . " Independent Electric, 781 F.2d at 727.

Furthermore, the fact that some evidence shows manifestations of a business does not merit a reversal of the Tax Court's decision. See Carter, 645 F.2d at 786-87 (facts showing that the taxpayers did not engage in yachting activities primarily for profit significantly outweighed facts indicating that taxpayers' activities had some manifestations of a business). Appellants bring to our attention the same facts that were before the Tax Court. Appellants have made no argument whatsoever as to why we

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Warden's previous ownership of boats began in 1947 and went on for twenty years--which certainly displays an understanding on the part of the Tax Court that no yachts were owned between 1974 and 1986); (ii) that Mr. Warden had found replacement counsel for all but two of his clients (the opinion states merely that Mr. Warden continued to operate his law firm); (iii) that the cost of additional insurance was double the cost of having only personal insurance (the opinion, however, does reference the need for additional insurance in general terms); and (iv) that Ms. Warden was deathly afraid of sailing on the ocean (this was clear in the admitted testimony of Mr. Warden but not referenced in the opinion itself).

should find that the Tax Court's decision should be overturned for clear error.

Appellants make two other brief contentions on appeal--both of which are without merit. First, Appellants argue that the Tax Court's use of the word "convince," in relation to Appellant's burden of proof, indicates that the Tax Court required a level of proof beyond the preponderance of the evidence. In its opinion, the Tax Court did state that "[b]ased on the entire record, we are not convinced that petitioners' primary objective was to make a profit." Yet this statement in no way indicates a movement away from the preponderance of the evidence standard. In fact, the Tax Court implicitly referenced such a standard when it stated that Appellants carried the burden of proof, but that the evidence was "more consistent" with the profit motive being just one, and not the primary, consideration.

Second, and distinct from their argument that the Tax Court misapplied the primary purpose test, Appellants make a brief argument that the application of the Ninth Circuit rule was both inconsistent with the practice of the Tax Court and violative of their constitutional rights. Appellants argue that the Tax Court, as a court of national jurisdiction, should follow its own rules and not the rules set out by the Ninth Circuit. Appellants, however, cannot point to Ninth Circuit case law supporting this notion and otherwise provide no cases where the Tax Court has expressly rejected binding precedent of the relevant circuit

in favor of the Tax Court rule. To the contrary, a brief review of recent Tax Court opinions instructs that the Tax Court regularly defers to the Ninth Circuit when the Ninth Circuit has provided a clear rule of law. See, e.g., Beaver Bolt Inc. v. Commissioner, 1997 WL 28676 (U.S. Tax Ct.); Summit Sheet Metal v. Commissioner, 72 T.C.M. (CCH) 1606 (1997).

In extending its weak argument, Appellants next contend that by following the Ninth Circuit, the Tax Court denied Appellants due process and violated the equal protection clause in that taxpayers not under the jurisdiction of the Ninth Circuit are treated more favorably. Appellants provide no support for this theory that the application of a rule by a United States Court of Appeals (as well as by the courts reviewable by that Court) can be unconstitutional where the underlying rule conflicts with a more favorable rule by another circuit. Where we follow clear Supreme Court precedent, but other circuit or trial courts do not, a constitutional violation cannot be said to have occurred with regard to the person against whom a correct rule of law has been applied.

For the foregoing reasons, we affirm the Tax Court's judgment finding deficiencies in Appellants' federal income taxes in the amount of $28,344 and adding an "addition to tax" under I.R.C. sec. 6662(b)(2) of $4,725.

AFFIRMED.

APPENDIX C

T.C. Memo. 1995-176

UNITED STATES TAX COURT

LEW WARDEN and NADJA J. WARDEN,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 4829-92. Filed April 17, 1995.

Lew Warden, for petitioners.

Debra K. Estrem, for respondent.

MEMORANDUM OPINION

RUWE, Judge: Respondent determined deficiencies in petitioners' Federal income taxes and additions to tax as follows:

Year	Deficiency	Addition to Tax Sec. 662(b)(2)
1986	$ 1,338	--
1989	28,344	$4,725

After concessions, (fn 1) the primary issue for decision is whether petitioners' yacht-related activities were engaged in for profit within the meaning of section 183. Subsidiary issues are: (1) Whether petitioners properly deferred recognition of a gain pursuant to section 1033; (2) whether petitioners are entitled to offset 1989 income by net operating losses that were allegedly incurred in 1987 and 1988; and (3) whether petitioners are liable for the addition to tax for substantial understatement of income tax pursuant to section 6662(b)(2) for the taxable year 1989.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The first stipulation of facts, second stipulation of facts, and attached exhibits are incorporated herein by this reference. Petitioners resided in Castro Valley, California, when they filed their petition.

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1. At trial, petitioners conceded the deficiency determinations for the taxable year 1986.

2. Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the taxable years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

3. Hereinafter, petitioners will be refer-

Beginning in 1953, through the years in issue, petitioner Lew Warden practiced law as a sole proprietor in Alameda County California. Petitioner Nadja Warden (fn 3) worked in her husband's law office keeping the books, but she received no pay or benefits. She held no other jobs. Mr. Warden retired from his law practice in 1993.

In 1974, petitioners acquired a one-sixth interest in an abandoned tennis and swim club in Pleasanton, California, from Mr. Warden's client, Julius Kahn. The remaining five-sixths of the property was held by Julius and his two brothers. As a result of controversies between the three brothers, the property had fallen into disrepair, and petitioners and Julius planned to reconstruct and operated the property as a recreational facility. Petitioners hoped to retire from the practice of law and spend their retirement years working in the "congenial and pleasant surroundings" of a recreational club. Petitioners moved onto the property and, until about 1980, attempted to repair it. However, the property never operated as a tennis and swim club.

Around 1980, the Kahn brothers contemplated partitioning the property. Ensuing litigation resulted in a 1980 judgment by the Alameda County Superior Court, which ordered the property sold and the proceeds

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red to as Mr. Warden or Mrs. Warden where necessary for clarification.

partitioned between petitioners and the Kahn brothers. The property was sold in 1980 for $316,000; petitioners received $183,642.15 of the sale proceeds, and the remainder was distributed to the Kahn brothers. In 1981, petitioners appealed from the partition judgment. In 1984, while the appeal was still pending, petitioners filed suit against various parties involved in the partition sale, alleging that the sale was fraudulent. The appeal and lawsuits alleging a fraudulent sale continued until 1989; at that time, all petitioners claims regarding the Pleasanton property were settled for $170,000. Petitioners thus received $353,642.15 from the disposition of the Pleasanton property ($170,000 plus prior payments of $183,642.15).

For tax purposes, petitioners assumed that the use of the Pleasanton property was 50 percent business and 50 percent residential, and treated the disposition of the property as having commenced in 1981 and concluded in 1989. On their 1989 Federal income tax return petitioners treated the business portion of the gain received from the Pleasanton property ($85,000) as "rolled over" into the cost of a yacht they had previously purchased in 1986.

In March 1986, petitioners ordered a 1986 Tayana model 55-foot, sailing yacht, with a 120 horsepower, freshwater-cooled diesel engine. It was to be built in Taiwan by Ta Yang Yacht Building Co. and sold through Windships, Inc., of Oakland, California (Windships). Petitioners prepared detailed specifications for the construc-

tion of the yacht, which were attached to the purchase agreement with Windships. The name of the yacht was Rocking Chair. Rocking Chair was spacious, nicely equipped, and furnished. It had a saloon, a galley, two bathrooms, and could comfortably sleep ten. It also had a telephone, a microwave oven, a coffeemaker, and a library, which contained periodicals, books, and videotapes. The total cost of Rocking Chair was $231,667, which included the cost of accessories and commissioning. Petitioners paid a deposit of $46,333 on March 24, 1986.

The yacht was delivered to petitioners on December 29, 1996, 6 months later than promised by the seller. Upon delivery, petitioners discovered many defects and failures to complete the yacht according to their specifications. Windships represented that it would correct the defects but did not do so in a timely manner. As a result, petitioners performed much of the work to prepare the yacht for commissioning. After the yacht was commissioned, petitioners continued to experience various equipment failures, including problems with the battery system, autopilot, and refrigerator as well as a transmission failure. Petitioners brought suit in 1989 for breach of contract, breach of warranty, and fraud against Windships, Ta Yang Yacht Building Co., and the owners of Windships. In 1992, petitioners obtained a default judgment against Windships in the amount of $153,164.50 and against Ta Yang Yacht Building Co. in the amount of $212,764.50. In 1993, the Superior Court also entered judgment against the owners of Windships, finding them person-

ally liable for the acts of Windships.

Mr. Warden was an experienced sailor, who had taken courses in nautical navigation, boat handling, disaster control, and diesel engine maintenance. At the age of 17, he was a seaman on a Swedish oil tanker. He had also been an Air Force navigator and pilot, performing both combat and instructional work. After purchasing their first sailboat in 1947, petitioners engaged in extensive cruising and yacht racing in the San Francisco Bay and offshore. They continued boating for the next 20 years, during which time they purchased and built or rebuilt three sailboats.

At the time petitioners purchased Rocking Chair, they were looking forward to enjoying life in somewhat warmer climates than the San Francisco Bay Area presented. Mr. Warden, then age 66, was becoming increasingly dissatisfied with the practice of law and sought to earn a living in a more pleasant recreational setting. The purchase of Rocking Chair was part of his plan for implementing this desire, and as a part of his plan, he intended to charter the yacht. At the time petitioners purchased Rocking Chair, they had a net worth of approximately $1,027,000.

Prior to purchasing Rocking Chair, petitioners had no experience with chartering. Petitioners' preparation for entering the chartering activity consisted of talking to friends, clients, and other acquaintances engaged in chartering activities; going out on a charterboat during a bar association

meeting in Jamaica; studying yachting magazines; and talking with people at resorts, such as Club Med. From this they learned of the going rates for different types of charters and decided that the most profitable and least burdensome type of chartering activity would be to conduct day-sailings as opposed to overnight or extended cruises.

Petitioners did not prepare a written business plan prior to purchasing Rocking Chair. Although Mr. Warden claimed to be very knowledgeable about the expenses involved in operating and maintaining a yacht, he claimed no such expertise with regard to income from chartering activities. The yacht salesmen at Windships represented to petitioners that they could earn substantial income chartering boats--about $36,000 per season as estimated by the salesmen. Although Mr. Warden was aware, prior to purchasing Rocking Chair, that there was a 55-foot yacht in Windships' marina that was being chartered by Windships, he never discussed the profitability of chartering with the owner of the yacht, nor did he check Windships' chartering records to verify the salesmen's statement. He simply concluded from several months of spending time at the harbor and watching the charter boat come and go, that "They were getting charters."

Windships informed petitioners of the chartering arrangement between it and the owners of the other 55-foot yacht that it was chartering. This arrangement involved Windships' maintaining the yacht and receiving 60 percent of the chartering reve-

nues, leaving the owners only 40 percent of the revenues. Petitioners desired a different arrangement, where they would perform most of the labor and maintain insurance on the yacht and receive 60 percent of the revenues rather than 40 percent. Mr. Warden prepared a detailed charter/lease agreement to this effect, which included charter rate schedules; however, the agreement was never signed by Windships. Petitioners did, in fact, perform most of the labor in cleaning and maintaining the yacht and kept a detailed log reflecting the use and maintenance of the yacht. In June 1988, after Rocking Chair's transmission failed, Mr., Warden moved onto the yacht, using it as his residence.

On June 19, 1987, petitioners filed a business tax declaration with the city of Oakland in the name of "Rocking Chair Cruises". Petitioners also obtained a seller's permit from the State of California and filed quarterly state, local, and district sales and use tax returns with the State of California, which covered the periods between January 1987 and December 1989. Petitioners obtained an employer identification number in the name of Rocking Chair Cruises from the Internal Revenue Service on June 30, 1987. Using this number, petitioners filed a Form 941 (Employer's Quarterly Federal Tax return) and remitted the required withholding tax for two employees who worked for them on a few occasions during 1987. These employees helped to clean the yacht and cut and lay carpet for the yacht. Petitioners determined that it was not feasible to continuing hiring people for such maintenance work and ceased using employees. Petitioners opened a separate

checking account in the name of Rocking Chair and drew checks on this account for expenses relating to Rocking Chair. However, most of the checks that were issued for yacht-related expenses were drawn on Mr. Warden's law practice account or on Mrs. Warden's personal account. Petitioners maintained a telephone on the yacht, the account for which was in the name of Rocking Chair, from April 14, 1987, through July 19, 1989. Petitioners also obtained additional insurance coverage for chartering activities but dropped this additional coverage in 1991. Petitioners obtained a Coast Guard certificate of documentation dated November 19, 1988, for recreational use only.

Petitioners made attempts to advertise Rocking Chair for charter. They ran an ad in the classified section of "Latitude 38" during March, April, and May 1988, and they ran an ad in the 1987 Pacific Bell Oakland Yellow Pages.

Rocking Chair was only chartered on a few occasions. In 1987, petitioners received three charters through Windships. In 1988 Rocking Chair was not chartered at all. In 1989, Mr. Warden took Rocking Chair south to Santa Barbara, where he listed it for sale with a broker. While there, he met a charterboat operator who was doing business as Sunset Kidd Sailing Charters (Sunset Kidd). Petitioners obtained three charters through Sunset Kidd in 1989. In 1990, petitioners chartered the yacht once and have not chartered it since.

Around 1989 or 1990, Mr. Warden attempted to enter into a working relationship with Mr.

Neil Weinberg, who owned a Tayana boat franchise. Mr. Warden anticipated starting a program to sell standardized Tayana boats, using Rocking Chair as a pilot for the program. As a part of the proposed sales program, customers would be taken on a cruise to Mexico where they would learn the details and techniques of sailing their new boats. This plan never materialized.

Petitioners attempted to sell Rocking Chair after they encountered defects and mechanical problems. Petitioners entered into various agency listing agreements, authorizing the agents to sell Rocking Chair. Petitioners entered into five such agreements in all; the first agreement was dated September 7, 1989, (fn 4) and the most recent agreement was dated October 14, 1992. Petitioners ran an ad in "SAIL" magazine for 2 months at the end of 1990 offering the yacht for sale, and they ran an ad in the classified section of "Latitude 38" from June 1991 through January 1992.

Petitioners reported large net losses on their Federal income tax returns (Schedule C) attributable to yacht-chartering activities. The following summary reflects the gross income, expenses, and net losses claimed by petitioners with respect to chartering activities:

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4. Although the evidence contains a central agency listing agreement that petitioners purportedly entered into with Gary Helms on Oct. 1, 1988, the agreement is not signed.

Taxable Year	Gross Income	Expenses**	Net Income (Loss)
1987	$2,118	$75,712	($73,594)
1988	5,429*	47,536	(42,107)
1989	8,189*	75,343	(67,154)
1990	638	81,876	(81,238)
1991	153	60,552	(60,399)
1992	0	45,885	(45,885)

*In each of the taxable years 1988 and 1989, $5,429 represents an amount that Mr. Warden allocated for his living on the yacht; it is not charter income.

**These expenses include depreciation claimed in each of the taxable years 1987 through 1992 of $40,225, $33,573, $38,139, $41,184, $40,496, and $34,626, respectively.

During these years, Mr. Warden continued to operate his law practice. The following summary reflects the gross income, expenses, and net income (losses) claimed by petitioners with respect to the law practice:

Taxable Year	Gross Income	Expenses**	Net Income (Loss)
1986	$146,027	$121,922	$24,105
1987	60,119	89,490	(29,371)
1988	163,021	65,297	97,724
1989	92,248	64,249	27,999
1990	63,880	41,278	22,602
1991	108,946	63,781	45,165
1992	4,720	12,939	0*

*Although reported expenses exceed reported gross income, indicating that petitioners

incurred an operating loss in 1992, they reported a net income (loss) of zero.

Petitioners maintained detailed computer records of the capital expenditures, depreciation, other expenses, and revenues generated by the yacht-related activities. Of 35 pages of records covering the years 1987 through 1990, 33 pages pertain to expenses, while only two pages pertain to income.

During the years in issue, petitioners admitted to using Rocking Chair on at least a few occasions for reasons unrelated to their chartering activities. These trips, however, do not appear in their operating log. The only trips that appear in petitioners' log were reflected as charters or as linked to testing or repairing the yacht and its equipment. Petitioners' maintenance log reflects the following trips through 1990:

Date	Port/Purpose of Trip
5/24/87	Golden Gate Bridge charter
5/31/87	Guest sail
6/6/87	Guest sail/promotion
6/13/87	Charter
8/14/87	Charter - 2 days
9/4/87	Depart for Sacramento shakedown cruise. Anchor at Angel Island.
9/5/87	Leave Angel Island; anchor in Lockport.
9/6/87	Leave Lockport; anchor in Sacramento. Stayed for 4 days. Depart for home on 9/10/87.
1/7/88	Depart for Puerto Rico for Ocean Navigator Instructional cruise.

	Stayed for 12 days.
7/2/88	Depart for Delta shakedown cruise. Anchor at Angel Island.
7/3/88	Leave Angel Island; anchor in Antioch.
7/4/88	Leave Antioch; anchor in Mandeville Cut. Stayed for 2 days. Depart for home on 7/6/88.
4/29/89	Sail to Sausalito for purpose of testing a potential crew member.
7/10/89	Begin trip south. Anchor at Sausalito.
7/11/89	Leave Sausalito; anchor at Half Moon Bay.
7/12/89	Leave Half Moon Bay; anchor at Santa Cruz.
7/13/89	Leave Santa Cruz; anchor at Monterey.
7/14/89	Leave Monterey; anchor at San Simeon. Stayed for 2 days.
7/16/89	Leave San Simeon; anchor at Pt. San Luis. Stayed until 9/3/89.
9/3/89	Leave Pt. San Luis; anchor at Santa Barbara.
9/10/89	Sail to Santa Cruz Island for the purpose of demonstrating the yacht, and testing Sunset Kidd charter boat operator.
9/11/89	Return to Santa Barbara.
10/8/89	Charter - 3 days.
11/7/89	Sail to Marina del Rey to repair water maker. Returned the next day.
11/20/89	Charter.
11/24/89	Charter.
12/1/89	Depart for Newport. Anchor at Ventura.
12/3/89	Leave Ventura; anchor at Oxnard.
12/5/89	Leave Oxnard; anchor at Marina

	del Rey.
12/6/89	Leave Marina del Rey; anchor at Long Beach. Stayed for almost 1 month.
1/2/90	Leave Long Beach; anchor at Newport. Stayed for almost 2 months.
2/25/90	Leave Newport; anchor at Dana Point.
2/26/90	Leave Dana Point; anchor at San Diego.
2/28/90	Leave San Diego; anchor at Ensenada, Mexico.
3/1/90	Leave Ensenada. Travelled north reaching Ventura again on 3/24/90. Stayed for 4 months.
7/2/90	Move from Ventura to Oxnard to check out Marina Sailing personnel. Stayed for almost 4 months.
10/28/90	Depart for Santa Barbara.
11/6/90	Leave Santa Barbara; anchor at Santa Cruz.
11/9/90	Leave Santa Cruz; arrive back in San Francisco.

At the time of trial, Mr. Warden had taken the yacht to Mexico, and Mrs. Warden was planning to move to Mexico to join him.

OPINION

We must first decide whether petitioners' ownership and operation of Rocking Chair were activities that were "not engaged in for profit" within the meaning of section 183(c). Section 183(a) provides generally that if an activity is not engaged in for profit, no deduction attributable to such activity shall be allowed, except as otherwise provided in

section 183(b). (fn 5) Section 183(c) defines an activity not engaged in for profit as "any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212."

Deductions are allowed under section 162 for the ordinary and necessary expenses of carrying on an activity which constitutes the taxpayer's trade or business. Deductions are allowed under section 212 for expenses paid or incurred in connection with an activity engaged in for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income. With respect to either section, however, the taxpayer must demonstrate a profit objective for the activities in order to deduct associated expenses. Jasionowski v. Commissioner, 66 T.C. 312, 320-322 (1976); sec. 1.183-2(a), Income Tax Regs. The profit standards applicable to section 212 are the same as those used in section 162. See Agro Science Co. v. Commissioner, 934 F.2d 573, 576 (5th Cir. 1991), affg. T.C. Memo.

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5. Sec. 183(b)(1) permits a deduction for expenses that are otherwise deductible without regard to whether or not the activity is engaged in for profit, such as interest and personal property taxes. Sec. 183(b)(2) permits a deduction for expenses that would be deductible only if the activity were engaged in for profit, but only to the extent of the total gross income derived from the activity

1989-687; Antonides v. Commissioner, 893 F.2d 656, 659 (4th Cir. 1990), affg. 91 T.C. 686 (1988); Allen v. Commissioner, 72 T.C. 28, 33 (1979); Rand v. Commissioner, 34 T.C. 1146, 1149 (1960).

Respondent argues that for purposes of section 183, a taxpayer must prove that profit was the primary purpose for engaging in the activity. This case is appealable to the Ninth Circuit Court of Appeals. The primary purpose standard has been followed by the Court of Appeals for the Ninth Circuit in determining whether the requisite profit objective exists. See Wolf v. Commissioner, 4 F.3d 709, 713 (9th Cir. 1993), affg. T.C. Memo. 1991-212; Polakoff v. Commissioner, 820 F.2d 321 (9th Cir. 1987), affg. T.C. Memo. 1985-197; Independent Elec. Supply v. Commissioner, 781 F.2d 724 (9th Cir. 1986) affg. T.C. Memo. 1984-472; Carter v. Commissioner, 645 F.2d 784 (9th Cir. 1981) affg. T.C. Memo. 1978-202 (disallowing deductions related to yacht chartering and writing activities under section 183); Hirsch v. Commissioner, 315 F.2d (9th Cir. 1963), affg. T.C. Memo. 1961-256.

Whether the required profit motive exists is to be determined on the basis of all the facts and circumstances of each case. Hirsch v. Commissioner, 315 F.2d at 373; Golanty v. Commissioner, 72 T.C. 411, 426 (1979), affd. without published opinion 647 F.2d 170 (9th Cir. 1981); sec. 1.183-2(a),

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less deductions allowed by sec. 183(b)(1).

Income Tax Regs. While the focus of the test is on the subjective intention of the taxpayer, greater weight is given to the objective factors than to the taxpayer's mere statement of his intent. Independent Elec. Supply, Inc. v. Commissioner, 781 F.2d at 726; Dreicer v. Commissioner, 78 T.C. 642, 645 (1982), affd. without published opinion 702 F.2d 1205 (D.C. Cir. 1983); sec. 1.183-2(a), Income Tax Regs. Petitioners have the burden of proving that they had the requisite intention and that respondent's determination that the activities were not engaged in for profit is incorrect. Rule 142(a); Welch v. Helvering, 290 U.S. 111 (1933).

Section 1.183-2(b), Income Tax Regs., sets forth some relevant factors for determining whether an activity is engaged in for profit. No one factor is controlling. Brannen v. Commissioner, 722 F.2d 695, 704 (11th Cir. 1984), affg. 78 T.C. 471 (1982); Golanty v. Commissioner, 72 T.C. at 426. The relevant factors are: (1) The manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisers; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, which are earned; the financial status of the taxpayer; and (9) the presence of elements of personal pleasure or recreation. Sec. 1.183-2(b), Income Tax Regs.

(1) Manner in which the taxpayer carries on the activity. We recognize that there are some manifestations of a business in petitioners' yacht-related activities. Petitioners kept records of the income and expenses and a detailed log reflecting the use and maintenance of the yacht. Petitioners opened a separate checking account in the name of Rocking Chair; however most of the checks that were issued for yacht-related expenses were drawn on Mr. Warden's law practice account or on Mrs. Warden's personal account. Petitioners also filed a business tax declaration, obtained a seller's permit, filed sales and use tax returns, obtained an employer identification number, obtained additional insurance, and maintained a telephone on the yacht. Petitioners advertised the yacht's availability for charter in the classifieds and the yellow pages; however, attempts to publicize the chartering activities were not significant. Petitioners also attempted to sell the yacht when they encountered defects and mechanical problems.

Petitioners did not prepare a written business plan prior to purchasing Rocking Chair. Petitioners relied on representations by the yacht salesmen at Windships that they could expect revenue of about $36,000 per season chartering the yacht. Petitioners did not check Windships' chartering records to verify the salesmen's statement, nor did they attempt to determine whether the represented income of $36,000 would be sufficient to cover anticipated expenses. Petitioners did not discuss the profitability of chartering with the owner of the other 55-foot yacht that was being chartered by Windships. Although petitioners tal-

ked to acquaintances in the chartering business and studied yachting magazines prior to purchasing Rocking Chair, there has been no showing of the specific nature of the information and advice they received from these sources. Even though petitioners kept records of their income and expenses, there has been no showing that they used these records to improve the profitability of the operation.

(2) The expertise of the taxpayer or his advisers. Mr. Warden was an experienced sailor, and he had experience maintaining and building yachts. However, petitioners had no experience with chartering. While they claimed to have gained knowledge of the chartering business through talking with acquaintances in the business and studying yachting magazines, no reliable evidence exists to show the specific nature of the information and advice that petitioners received from these sources.

(3) Time and effort expended by the taxpayer in carrying on the activity. Petitioners spent a good deal of time cleaning and maintaining the yacht; however, these activities are also consistent with use of the yacht for recreation.

(4) Expectation that assets used in the activity would appreciate in value. Petitioners argue that they thought the yacht would appreciate in value because of inflation and the declining value of the dollar. Petitioners did not offer any evidence as to their measurement of the yacht's expected appreciation.

(5) The success of the taxpayer in car-

rying on other similar or dissimilar activities. Petitioners have not previously engaged in yacht-chartering activities.

(6) The taxpayer's history of income and losses with respect to the activity, and (7) the amount of occasional profits, if any, which are earned. Petitioners' chartering activities generated substantial losses over a period of six years, which petitioners used to offset taxable income from other sources. A record of substantial losses over many years and the unlikelihood of achieving a profitable operation are important factors bearing on the taxpayer's intention. Cannon v. Commissioner, 949 F.2d 345, 352 (10th Cir. 1991), affg. T.C. Memo. 1990-148; Golanty v. Commissioner, 72 T. C. at 426-427. The presence of such losses in the formative years of a business is not inconsistent with an intent to achieve a later profitable level of operation; however, the goal must be to realize a profit on the entire operation, which presupposes sufficient future net earnings from the activity to recoup the losses. Golanty v. Commissioner, supra at 427. In the present case, petitioners reported losses over 6 years of operation totaling $370,377.

(8) The financial status of the taxpayer. When petitioners purchased Rocking Chair, their net worth was approximately $1,027,000. During the period in which petitioners operated Rocking Chair, they received income from Mr. Warden's law office and other sources such as interest. While such non-chartering income was not overwhelming, petitioners did obtain a tax benefit from the losses generated by the chartering acti-

vities.

(9) The presence of elements of personal pleasure or recreation. Mr. Warden was no longer happy in his practice of law, and he was of an age where he was ready to retire. Petitioners wanted to live in a more pleasant, recreational setting. They clearly enjoyed sailing and had engaged in sailing activities for recreation for at least 20 years prior to purchasing Rocking Chair. The yacht was custom built and was equipped with all the amenities. Beginning in 1988, Mr. Warden lived on the yacht and used it as his residence. Petitioners admittedly used Rocking Chair for activities unrelated to chartering but did not document these trips in their operating log. Petitioners' documented trips on Rocking Chair were to locations such as Sacramento, Santa Cruz, Monterey, Santa Barbara, Newport, San Diego, and Ensenada, Mexico. Petitioners often stayed for extended periods of time at these locations.

Based on a consideration of all the above factors and having heard petitioners' testimony at trial, we believe that they honestly hoped that their yachting activity would generate a profit. Profit was one objective of their activity. However, to prevail, petitioners must show that their yachting activities were engaged in primarily for the purpose of making a profit.

Petitioners argue that they would not have purchased Rocking Chair unless their primary objective was to offer it for charter and thereby earn a livelihood. Peti-

tioners argue that due to limited finances, they could not have used Rocking Chair primarily for personal purposes. However, at the time petitioners purchased Rocking Chair, they had an estimated net worth of over $1 million, and Mr. Warden was still generating income from the law practice. We cannot overlook the significant recreational elements associated with the yacht. Petitioners loved to sail. They were ready to retire and wanted to live in a pleasant, recreational setting. They did, in fact, travel to many locations. These factors strongly indicate a personal objective.

Petitioners contend that the losses sustained as a result of their chartering activities were attributable to unforeseen circumstances, consisting of repeated equipment failures and failures of the seller and manufacturer to correct the yacht's defects. Losses sustained because of unforeseen or fortuitous circumstances beyond the control of the taxpayer do not necessarily indicate that the activity was not engaged in for profit. Engdahl v. Commissioner, 72 T.C. 659, 669 (1979); sec. 1.183-2(b)(6), Income Tax Regs. There is evidence that some of petitioners' problems stemmed from mechanical defects. However, petitioners failed to conduct the type of preliminary investigations that one would expect from someone who was motivated primarily by a profit objective. Further inquiry might have given petitioners into the likelihood off many of the problems they encountered. See Thomas v. Commissioner, 84 T.C. 1244, 1278 (1985), affd. 792 F.2d 1256 (4th Cir. 1986).

Where taxpayers have both personal and profit objectives for engaging in an activity, it is our task to determine which was "primary". Based upon the entire record, we are not convinced that petitioners' primary objective was to make a profit. See Snyder v. United States, 674 F.2d 1359, 1362-1364 (10th Cir. 1982). Rather, the evidence is more consistent with the conclusion that petitioners wished to retire from the practice of law, had a desire to sail, had the financial resources to pursue that desire, and had some hope that they could combine their dream retirement with an income-producing venture. Based on this record, we simply do not believe that petitioners' profit objective was the primary or dominant reason for engaging in the activity in question.

We hold that petitioners' yacht-related activities were not engaged in for profit within the meaning of section 183(c). Petitioners' deduction of the loss associated with these activities is, therefore, subject to the limitations set forth in section 183(b).

Respondent disallowed the entire loss that petitioners claimed in 1989 regarding the yacht. As noted previously, section 183(b)(1) permits a deduction for expenses that are otherwise deductible without regard to profit objective, such as interest and taxes. Included in petitioners' claimed loss was an interest expense deduction of $15,782 and a tax deduction of $3,908. Respondent makes no claim that these amounts were not paid. Rather, respondent's position in both the notice of deficiency and on brief is that

petitioners were not engaged in the chartering activity for a profit. Petitioners are, therefore, entitled to deduct these items pursuant to section 183(b)(1). (fn 6) Because these deductions exceed the total gross income reported from the activity, (i.e., $8,189), petitioners are not allowed any deduction pursuant to section 183(b)(2).

Next, we must determine whether petitioners may defer recognition of the gain on the disposition of the Pleasanton property pursuant to section 1033. Section 1033(a) provides that if property is compulsorily or involuntarily converted "as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof", then the gain from the conversion shall not be recognized, provided the converted property is replaced by property that is "similar or related in service or use" within a specified time period.

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6. Respondent disallowed the entire loss, or the difference between the gross income and the total expenses, claimed by petitioners with regard to yacht-chartering activities. Because this calculation subtracts out an amount equal to the gross income from the activity, petitioners have already been allowed a "deduction" of $8,189. Therefore, petitioners' total expenses of $19,690 for interest and taxes must be reduced by the $8,189 already taken into account, leaving an allowable deduction of $11,501.

Whether replacement property is similar or related in service or use depends upon whether the taxpayer's use of the replacement property is similar to his use of the original property. Filippini v. United States, 318 F.2d 841, 844 (9th Cir. 1963); Wheeler v. Commissioner, 58 T.C. 459, 463 (1972). Petitioners have conceded that if we find that their yacht related activities do not constitute a trade or business, they are not entitled to roll over the business portion of the gain from the Pleasanton property into the cost of Rocking Chair. Accordingly, we uphold respondent's determination on this issue. (fn 7)

Alternatively, petitioners contend that pursuant to section 172(b)(1)(B), they are entitled to carry forward certain net operating losses for taxable years 1987 and 1988 to offset any taxable income for 1989. Petitioners argue that the net operating losses would fully absorb any income required to be recognized for 1989.

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7. Even if the replacement property were similar or related in service of use, there has been no involuntary conversion of the Pleasanton property within the meaning of sec. 1033. Petitioners contend that the court-ordered sale of the Pleasanton property, which petitioners challenged on appeal and later alleged to be fraudulent, constituted a theft or seizure of their property within the meaning of sec. 1033(b). There has been no prior adjudication or admission of fraud, and petitioners have presented no

Petitioners did not claim any net operating loss carryover on their 1989 Federal income tax return; this issue was first raised in the petition. Petitioners bear the burden of proving that they are entitled to a net operating loss carryover. Rule 142(a). Other than their 1987 and 1988 returns, petitioners have offered no evidence that they sustained losses in these years. (fn 8) An entry on a tax return does not prove prove the existence of losses. Halle v. Commissioner, 7 T.C. 245 (1946), affd. 175 F.2d 500 (2d Cir. 1949); Klukwan, Inc. v. Commissioner, T.C. Memo. 1994-402. Therefore, petitioners have not met their burden of proof on this issue. (fn 9)

Respondent determined that petitioners

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evidence that the court-ordered sale was fraudulent or constituted theft as that term is used in the Internal Revenue Code. See Hope v. Commissioner, 55 T.C. 1020, 1034-1035 (1971), affd. 471 F.2d 738 (3d Cir. 1973).

8. We note that petitioners' reported net operating losses from the taxable years 1987 and 1988 arose in large part from the losses from their yacht-chartering activities.

9. Even had petitioners met their burden of proving the existence of net operating losses, they have not shown that they made a proper election to relinquish the 3-year carryback period, such that they would be entitled to carry any net operating loss forward. Sec. 172(b)(3)(C).

are liable for the addition to tax under section 6662(b)(2) for the taxable year 1989. Section 6662, which is applicable to returns due after December 31, 1989, imposes an addition to tax in an amount equal to 20 percent of the portion of any underpayment attributable to a substantial understatement of income tax. Sec. 6662(a), (b)(2). An understatement is substantial if it exceeds the greater of 10 percent of the correct tax or $5,000. Sec. 6662(d)(1)(A).

Petitioners bear the burden of proving that respondent's determination of an addition to tax is erroneous. Rule 142(a). Petitioners presented no evidence to rebut respondent's determination, and they made no argument in brief separately challenging their liability for the section 6662(b)(2) addition to tax for the taxable year 1989. Accordingly, respondent's determination is sustained.

Decision will be entered under Rule 155.

APPENDIX D

TAX COURT DECISIONS

1. Recent Tax Court Decisions, Post Commissioner v. Groetzinger, 480 U.S. 23 (1987), and All Appealable to the Ninth Circuit, Where The Tax Court Has Applied the "Actual and Honest" Intent to Profit Test:

Thomas J. Barnes, 64 TCM 1552 (1992).
Jerome F. Bischoff, 69 TCM 1741, 1744 (1995).
Frank Bizjak, 67 TCM 3142, 3143-3 (1994).
Roland C. Briggs, 67 TCM 2484, 2994 (1994)
David E. Buckner, 68 TCM 352, 354-355 (1994).
Harris Cashman, 58 TCM 270, 272 (1989), aff'd 9th Circuit unpublished opinion 5/2/91.
James E. Clayton, 65 TCM 2371, 2372-2373 (1993), also citing Commissioner v. Groetzinger, supra.
William James Courville, 71 TCM 2496, 2497 (1996).
Richard H. Daley, 71 TCM 3147, 3147-3 (1996).
Estate of Daniel J. Dickerson, 73 TCM 2506, 2513 (1997).
Elliott v. C.I.R., 90 T.C. 960, 970 (1988).
Barbara Jean Crail, 65 TCM 1846, 1848 (1993).
George W. Gagnon, 72 TCM 701, 703 (1996), also citing Commissioner v. Groetzinger, supra.
William B. Hart, 69 TCM 1822, 1823 (1995).
Gerald K. Hilliard, 70 TCM 898, 900 (1995).
Clarence A. Hunt, Jr., 72 TCM 457 (1996).

Richard L. Kaufman, 68 TCM 4, 6 (1994).
Charles D. Keller, 66 TCM 682, 683 (1993).
Keanini v. C.I.R., 94 TC 41, 46 (1990).
William R. King, Jr., 65 TCM 2811, 2813 (1993).
John H. Lewis, 64 TCM 269, 274 (1992).
Joseph E. Machado, 70 TCM 1165, 1170 (1995).
Mark Massingill, 71 TCM 2651, 2654 (1996).
Hoolae Paoa, 66 TCM 377 (1993).
Geraldine H. Pearson, 71 TCM 2109, 2112 (1996).
Trilby Pederson, 68 TCM 1142, 1145 (1994).
Bernard Michael Reed, 70 TCM 1485, 1486 (1995), also citing Commissioner v. Groetzinger, supra.
Dennis W. Schillinger, 60 TCM 1470, 1477 (1990), aff'd by Order 9th Circuit, 91-70386, 8/12/93, "For the reasons given by the Tax Court in its opinion . . . "
Sheldon M. Sisson, 68 TCM 1078, 1083 (1994).
Kenneth A. Smith, 65 TCM 2289, 2295 (1993).
Joseph Spear, 68 TCM 238, 240 (1994).
Edward A. Underwood, 58 TCM 731, 734 (1989).
Lee W. Yates, 72 TCM 1193, 1195 (1996).

2. Recent Tax Court Decisions, All Appealable to the Ninth Circuit, Where the Tax Court Has Equivocated As to the Proper Test:

Arrowhead Mountain Getaway, Ltd., 69 TCM 1805, 1818 (1995): "Whether the participants must have profit as their 'primary purpose', or whether it suffices that they have an 'actual and honest' profit objective, does not matter. In the case at hand, petitioner and intervenor have shown neither."

William T. Heywood, 68 TCM 1240, 1242 (1994). No standard mentioned.

Estate of Donald E. Kettleberg, 70 TCM 150, 152 (1995): Tax Court declined to apply the primary profit intent rule on the the ground that it could not predict that the 9th Circuit would apply a particular rule.

John J. Shell, 67 TCM 2692, 2694 (1994): "good faith purpose of making a profit"; "a sporadic activity, a hobby, or an amusement diversion does not qualify", citing Commissioner v. Groetzinger, supra.

Lester R. Westphal, 68 TCM 1038, 1041 (1994): "basic or dominant motive to realize a profit or taxable income"; "expectation of profit need not be reasonable"; "must be a good faith objective of making a profit". (Covering all bases!)

3. Tax Court Cases Holding That an Activity Entered into for the Purpose of Supplementing Retirement Income Is An Activity for Profit.

David E. Buckner, 68 TCM 352, 354-355 (1994). (Citing "actual and honest" test.)

Robert W. Dickson, 47 TCM 509, 511, 512, 514 (1983). (Citing "actual and honest" test.)

Robert Scott Cronhardt, 52 TCM 287, 288, 291, 292 (1986). (Citing "actual and honest" test, and appealable to the 9th Circuit.)

Engdahl v. C.I.R., 646 TC 659, 661, 666 (1979). (Citing "predominant purpose" and "bona fide and good faith" tests.

Edwin B. Feldman, 55 TCM 450, 451, 452 (1988).

(Citing both "actual and honest" and "primary profit motive" tests.)

D.K. Hatch, 57 TCM 280, 281, 282 (1989). (Citing "actual and honest" test.)

William Hellings, 67 TCM 1988, 1989, 1991 (1994), citing "actual and honest" test.)

* * *

APPENDIX E

Internal Revenue Code Sections and Regulations

Internal Revenue Code:
Title 26, U.S.C.

Sec. 162. Trade or business expenses

(a) In general.-- There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.

* * *

Sec. 167 - Depreciation

(a) General rule.-- There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)--

1. of property used in the trade or business, or

2. of property held for the production of income.

* * *

Sec. 183. Activities not engaged in for profit

(a) General rule.-- In the case of an activity engaged in by an individual or an S corporation, if the activity is not engaged in for profit, no deduction attributable to such activity shall be

allowed under this chapter except as provided in this section.

(b) Deductions allowable.-- In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed--

(1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and

(2) a deduction equal to the amount of the deductions under this chapter for the taxable year only if such activity was engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

(c) Activity not engaged in for profit defined.-- For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

(d) Presumption.-- If the gross income derived from an activity for 3 or more of the taxable years in the period of 5 consecutive taxable years which ends with the taxable year exceeds the deductions attributable to such activity (determined without regard to whether

or not such activity is engaged in for profit), then, unless the Secretary establishes to the contrary, such activity shall be presumed for the purposes of this chapter for such taxable year to be an activity engaged in for profit. In the case of such an activity which consists in major part of the breeding, training, showing, or racing of horses, the preceding sentence shall be applied by substituting "2" for "3" and "7" for "5".

* * *

Sec. 212. Expenses for production of income. In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year--

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income . . .

* * *

TREASURY REGULATIONS

26 CFR 1.183-2 Activity not engaged in for profit defined.

(a) In general. For purposes of section 183 and the regulations thereunder, the term activity not engaged in for profit profit means any activity other than one with respect to which deductions

are allowable for the taxable year under section 162 or under paragraph (2) or (2) of section 212. Deductions are allowable under section 162 for expenses of carrying on activities which constitute a trade or business of the taxpayer and under section 212 for expenses incurred in connection with activities engaged in for the production or collection of income or for the management, conservation or maintenance of property held for the production of income. Except as provided in section 183 and sec. 1.183-1, no deductions are allowable for expenses incurred in connection with activities which are not engaged in for profit. Thus, for example, deductions are not allowable under section 162 for activities which are carried on primarily as a sport, hobby, or for recreation. The determination whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case. Although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit. * * * In determining whether an activity is engaged in for profit, greater weight is given to objective facts than to the taxpayer's mere statement of his intent.

* * *

(9) Elements of personal pleasure or recreation. The presence of personal

motives in carrying on an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit. An activity will not be treated as not engaged engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.

* * *

1.212.1(c) - The question of whether or not a transaction is carried on primarily for the production of income or for the management, conservation, or maintenance of property held for the production of income, rather than primarily as a sport, hobby, or recreation, is not to be determined solely from the

intention of the taxpayer but rather from all the circumstances of the case. For example, consideration will be given to the record of prior gain or loss of the taxpayer in the activity, the relationship between the type of activity and the principal occupation of the taxpayer, and the uses to which the property or what it produces is put by the taxpayer.

* * *

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JAN 21 1998
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No. 97-845

In the Supreme Court of the United States

OCTOBER TERM 1997

LEW WARDEN AND NADJA J. WARDEN, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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12 pp

QUESTION PRESENTED

Whether expenses incurred in owning and operating a yacht that is used primarily for personal pleasure rather than to generate a profit may be deducted under Section 162 or 212 of the Internal Revenue Code.

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Internal Revenue Code (26 U.S.C.):
§ 162 ..... 3, 4, 5
§ 183(a) 3, 4
§ 183(b) 4
§ 183(c) 4
§ 212 ..... 3, 4, 5, 6
§ 280A(c)(1)(A) 4

In the Supreme Court of the United States

OCTOBER TERM 1997

No. 97-845

LEW WARDEN AND NADJA J. WARDEN, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 3-11) is reported unofficially at 79 A.F.T.R.2d 97-2168. The opinion of the Tax Court (Pet. App. 12-38) is reported unofficially at RIA T.C. Memo ¶ 95,176.

JURISDICTION

The judgment of the court of appeals was entered on April 2, 1997. The petition for rehearing was denied on August 20, 1997. The petition for a writ of certiorari was filed on November 18, 1997. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioners claimed depreciation and operating expense deductions in 1989 in connection with their ownership of a yacht. The Commissioner concluded

that, although the yacht was sometimes chartered, petitioners did not operate the yacht with the primary objective of deriving a profit. The Commissioner therefore disallowed the claimed deductions to the extent that they exceeded the gross income received from the charters.

Petitioners sought review of the asserted deficiency in the Tax Court. The Tax Court upheld the Commissioner's determination. The court rejected petitioners' assertion that they needed to prove only a good-faith profit motive to be entitled to the contested deductions. The court noted that "[t]he primary purpose standard" has been consistently followed in the Ninth Circuit, to which appeal lies in this case (Pet. App. 27). The court concluded that, although there were "some manifestations of a business" in petitioners' activities (*id.* at 29), the evidence was more consistent with the conclusion that petitioners neither acquired nor operated the yacht primarily for profit. Instead, it appeared that petitioners "wished to retire from the practice of law, had a desire to sail, had the financial resources to pursue that desire, and had some hope that they could combine their dream retirement with an income-producing venture" (*id.* at 34).

2. The court of appeals affirmed (Pet. App. 3-11). The court held that the Tax Court had correctly applied the primary purpose test to the facts of this case (*id.* at 9-11). The court further stated that it is well-established in the Ninth Circuit that a taxpayer must prove a primary profit motive to be entitled to business expense deductions, and that its "holdings in this area are in line with those of the Supreme Court" (*id.* at 5, citing *Commissioner* v. *Groetzinger*, 480

U.S. 23, 25 (1987), and *United States* v. *American Bar Endowment*, 477 U.S. 105, 110 n. 1 (1986)).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. Section 162 of the Internal Revenue Code authorizes the deduction of all ordinary and necessary expenses paid or incurred in carrying on a trade or business. 26 U.S.C. 162. Section 212 of the Code authorizes the deduction of all the ordinary and necessary expenses paid or incurred for the production of income or for the management, conservation, or maintenance of property held for the production of income. 26 U.S.C. 212. In *Commissioner* v. *Groetzinger*, 480 U.S. 23, 35 (1987) (emphasis added), this Court explained that "to be engaged in a trade or business * * * the taxpayer's *primary* purpose for engaging in the activity must be for income or profit." Similarly, in *United States* v. *American Bar Endowment*, 477 U.S. 105, 110 n.1 (1986) (emphasis added), the Court stated that "[t]he standard test for the existence of a trade or business for purposes of Section 162 is whether the activity was entered into with the *dominant* hope and intent of realizing a profit" (internal quotations omitted).[1]

Section 183(a) of the Internal Revenue Code expressly precludes the deduction by individuals of expenses incurred in an activity "not engaged in for

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[1] In *United States* v. *Gilmore*, 372 U.S. 39, 45 (1963), the Court explained that deductions under (what is now) Section 212 are "subject to the same limitations and restrictions that are applicable to those allowable under" (what is now) Section 162.

profit" (26 U.S.C. 183(a)). The statute defines an activity "not engaged in for profit" as any activity "other than one with respect to which deductions are allowable" under Sections 162 or 212. 26 U.S.C. 183(c). For activities "not engaged in for profit," Section 183(b) permits deductions only to the extent of the gross income derived from that activity. 26 U.S.C. 183(b).

The decision of the court of appeals correctly implements this statutory scheme. The Tax Court found, as a matter of fact (Pet. App. 34), that the taxpayer's activities were not for the "primary purpose [of] * * * profit" (*Commissioner* v. *Groetzinger*, 480 U.S. at 35) and that deductions were therefore not permitted under Sections 162 or 212. The Tax Court then properly allowed the taxpayer to claim the deductions only to the extent of the income derived from the activity under Section 183(b). There is thus no basis for petitioners' contention (Pet. 3, 17-18) that the decision in this case conflicts with the decisions of this Court in *Commissioner* v. *Groetzinger*, *supra*, and *United States* v. *American Bar Endowment*, *supra*. Indeed, the court of appeals expressly relied on those decisions in its opinion in this case (Pet. App. 5).

2. Petitioners also err in contending (Pet. 18-20) that the decision in this case conflicts with the decision of this Court in *Commissioner* v. *Soliman*, 506 U.S. 168 (1993). In *Soliman*, this Court did not address whether a primary profit motive is required to permit a deduction under Sections 162 or 212. Instead, the Court addressed the circumstances under which the home of a taxpayer qualifies as his "principal place of business" for purposes of the home office deduction permitted under Section 280A(c)(1)(A) of the Code. 506 U.S. at 174-175. The decision in *Soli-*

man dealt with the specifics of the "home office" deduction statute; it did not determine or alter the "primary purpose" test under Sections 162 and 212.

In any event, the legal test that petitioner advocates is not materially different from the test actually applied in the courts below. Petitioner argues that, in determining the availability of business deductions, courts should compare the profit motive to "the other purposes which motivated the taxpayer to enter into or continue a questioned activity" (Pet. 19). That is exactly what the Tax Court did in this case. The court found that petitioners "clearly enjoyed sailing and had engaged in sailing activities for recreation for at least 20 years" (Pet. App. 32), used the yacht "for activities unrelated to chartering" (*ibid.*) and "had a desire to sail" (*id.* at 34). The record thus amply supports the court's conclusion that petitioners were motivated primarily by personal pleasure and not primarily by profit.

3. Petitioners further err in contending (Pet. 2, 7-12) that the decision in this case conflicts with the decisions of other circuits. The cases that petitioners cite do not involve a comparison of profit motive to other motives because there was either (i) no profit motive at all or (ii) no recreational or other personal motive. In the absence of multiple motivations for an acitivity, there is obviously no need for a court to address whether the profit motive was the "primary" motive for the activity.

At one end of the spectrum are the cases cited by petitioners in which courts found that there was no profit motive whatsoever. In those cases, the courts were not required to determine whether the taxpayers had a "primary" profit motive either because the underlying transaction lacked economic substance

(*Ferguson* v. *Commissioner*, 29 F.3d 98, 102 (2d Cir. 1994)) or because the taxpayers lacked an "actual and honest" or "bona fide" profit motive (*Hendricks* v. *Commissioner*, 32 F.3d 94, 97 (4th Cir. 1994); *Burger* v. *Commissioner*, 809 F.2d 355, 358 (7th Cir. 1987); *Osteen* v. *Commissioner*, 62 F.3d 356, 358 (11th Cir. 1995)).[2]

At the other end of the spectrum, petitioners cite four cases in which there was no motive other than profit. In two of those cases (*Ranciato* v. *Commissioner*, 52 F.3d 23, 25 (2d Cir. 1995); *Cornfeld* v. *Commissioner*, 797 F.2d 1049, 1053 (D.C. Cir. 1986)), the courts made an explicit finding that there was no amusement or pleasure motive.[3] In the remaining two (*Evans* v. *Commissioner*, 908 F.2d 369, 374 (8th Cir.

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[2] Indeed, in *Hendricks* v. *Commissioner*, *supra*, the Fourth Circuit expressly endorsed the "primary" profit motive standard. The court cited its own earlier decision in *Antonides* v. *Commissioner*, 893 F.2d 656, 659 (4th Cir. 1990), and also this Court's decision in *Groetzinger*, in holding that "an expense is not deductible under Section 212 unless the taxpayer enters into the transaction in which the expense is incurred primarily for profit." 32 F.3d at 97 n.6.

[3] In *Ranciato*, the Second Circuit noted that "if the possibility that petitioners performed these labors for pleasure is eliminated, the only remaining motivation is profit." 52 F.3d at 28. Similarly, in *Cornfeld*, the District of Columbia Circuit distinguished the facts of that case from the "large class of cases where profit objective is reasonably placed in doubt because the taxpayer derives an intangible personal benefit from the purported business." 797 F.2d at 1052. The court stated in *Cornfeld* that "taxpayer's aircraft charter activities were not a hobby masquerading as a business," taxpayer was "not a pilot or skydiver," did not "amuse himself by collecting airplanes" and that "[n]othing in the record suggests that taxpayer bought this jet as a personal plaything." *Ibid.*

1990); *Smith* v. *Commissioner*, 937 F.2d 1089, 1095 (6th Cir. 1991)), there is an implicit assumption that there was no amusement or pleasure motive, for those cases involved taxpayers who were engaged in *passive* tax-sheltered investments that implicate no recreational or hobby activity.[4] See also *Peat Oil and Gas Associates* v. *Commissioner*, 100 T.C. 271, 284-286 (1993) (Swift, J., concurring) ("the primary profit-objective test should only apply when distinguishing between a hobby and a trade or business activity" and "should not apply generally to typical passive, tax-sheltered investments that are structured largely on the basis of the extensive tax benefits that Congress has made available.").

There is thus no conflict among the circuits or other reason to warrant further review of the decision in this case.

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[4] The Sixth Circuit expressly endorsed the "primary" profit motive standard in *Hayden* v. *Commissioner*, 889 F.2d 1548 (6th Cir. 1989). The court stated in that case that "[t]he threshold inquiry in determining whether an activity is a trade or business or is carried on for the production of income is whether the activity is engaged in for the *primary* purpose and *dominant* hope and intent of realizing a profit." 889 F.2d at 1552 (emphasis added).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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